WESTWOOD CAPITAL, LLC

OPINION

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The Prudential Regulation of Modern Financial Institutions:
Thoughts Behind and Beyond the "Volcker Rule"

*The below was first published online by **The New York Times** earlier today, as part of its Dealbook blog, edited by Andrew Ross Sorkin. Please do not hesitate to offer comment at the Times' link below[1].*

Overview

Notwithstanding all the riveting talk about political motivations, President Obama has finally decided to wrest control of financial reform efforts from his somewhat tone-deaf minions and the "too-hard-to-tackle"[2] crowd in Congress. Better late than never. But in belatedly joining forces with Paul Volcker, the man who will ultimately go down in history as the wisest regulator of his generation (sorry, Maestro Greenspan), Mr. Obama has waded into an immeasurably complicated debate that is enormously difficult for the general public to comprehend.

Regulation of the financial sector of economies is a subject that easily offers as many opinions as there are people who study, write on, and implement regulation. Mr. Volcker's Group of Thirty report, compiled a year ago during the depths of the financial crisis, is a work we fundamentally agree with in most respects. But it is written in policymakers' prose, the full meaning of which eludes many legislators—to say nothing of the public and some in the financial press. In his testimony Tuesday, Mr. Volcker did a yeoman's job of laying things out for the Senate Banking Committee, and he dispensed with the notion that his proposals would be too difficult to implement or would yield consequences he neither intends or hasn't already considered and accommodated. But the very fact that we so enjoyed the give-and-take between Chairman Volcker and the committee members, being way too wonkish ourselves, gives us pause with regard to the appreciation of this critical issue by a broader constituency.

We are also motivated by our alarm at Senator Dodd's 'don't let the door hit you on the way out' farewell to Mr. Volcker at the conclusion of Tuesday's hearing, in which the Senator noted that the wise man's suggestions might threaten the political likelihood of getting any financial industry reform bill through Congress.

So, today—at the risk of further upsetting the Senate Banking Committee's delicate political apple cart—we endeavor to offer our views on prudential regulation[3] in a simple manner that has some chance of being explicable to the average businessperson, and to even a nonfinancially oriented member of Congress about whose vote Mr. Dodd is so concerned.

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[1] The New York Times - Dealbook - Another View: Looking Beyond the Volcker Rule
[2] Nod to Gretchen Morgenson, "Resetting the Moral Compass," *NYT*, Jan. 24, 2010
[3] "The Prudential Regulation of Modern Financial Institutions" does sound a bit eggheady, but it's just a fancy way of saying "the exercise of sound judgment in setting the rules for the operation of financial businesses."

To start, let's divide the financial regulatory issues currently being debated into three categories:

(i) Size of financial institutions and their required capital base;
(ii) Appropriateness of activities and valuation of assets; and
(iii) Liabilities and other leverage.

Why we care about all this is self-evident, especially in light of recent history. But the government's role in regulating the financial system has for centuries been, and should be, a matter of ongoing debate. It is clear, however, that government, as executor of society's political will, has in modern times taken a sufficient stake (through deposit insurance and explicit or implicit central bank support) in the institutions it charters or licenses to conduct "banking," in any of its direct or indirect guises, to have more than just a passing interest in the day-to-day activities of such institutions.

Before going further, there is much being made of the notion of "resolution authority." While it is appropriate to note that previous regulation did not provide a clear mechanism for the orderly wind-down of troubled bank holding companies and investment banks, the idea that a new regulatory environment must provide such a mechanism is not *sui generis*. Any systemic regulatory solution that fails to provide for orderly remediation (or, as Mr. Volcker colorfully termed it, "euthanasia") is no system at all. For the purpose of this discussion, we assume its existence in any future regime.

Institutional Size and Capitalization

Much has been made lately of limiting too-big-to-fail institutions by just how "big" we are willing to have them be in the first place. We believe there are two reasons for this focus. First, it is knee-jerk normal to conclude that if you want to make sure financial institutions are not too big to fail, simply make them smaller so the collapse of a given institution won't bring down the entire system. Second, the remaining proponents of efficient market theory and financial industry deregulation (as unpopular as they may be—sorry again, Mr. Greenspan) have fallen back on size limits as being more palatable to their ideology (after all, Adam Smith himself warned against allowing banks to grow too large) than the notion of government overly messing around with the plumbing of banks' assets, liabilities, and freedom to conduct business.

We believe, however, that the issue of institutional size is both grossly misunderstood and often a red herring used to distract from the real issues. The truth is, one can have a very prudent financial system with fewer but larger institutions; look to Canada by way of example.

This is not to say that we oppose restrictions on overconsolidation of the industry. We think the current (recently loosely applied) restriction on depository market share to 10% of national deposits is sensible, as it promotes healthy competition and prevents systemic overreliance on a given institution's management. But if an institution is properly capitalized with ample permanent equity (more about this below), size really shouldn't matter. Of course, if an institution grows large by raising copious amounts of equity capital with little indebtedness, it may not be all that popular with shareholders, who greatly prefer seeing their return on equity benefit from a healthy amount of balance sheet leverage (debt or deposits). From a prudential regulatory perspective, however, this isn't the government's problem. It only means that banks will be somewhat less profitable on a per-share basis and may be constrained to more modest growth. So, even if banks are offered some flexibility on the issue of market share of national deposits, as the administration is suggesting, we think this issue pales in comparison to those of greater equity capital requirements and limits on nondeposit leverage

Within reason, large size may actually be critical for the United States to be able to field institutions that are competitive with other nations' global banks. Our financial system certainly doesn't operate in a vacuum, and the ability to service large-bank customers very often depends on operationally critical mass.

Regulating Financial Institutions' Assets

In mid-January, in a part-populist, part-prudential move, the White House announced a policy initiative aimed at raising tax revenue by providing a disincentive to banks to operate with substantial amounts of nondepository liabilities. A week later, with Mr. Volcker by his side, the president took on the asset side of banks' balance sheets.

Other than establishing minimum required capital levels, bank regulation's most important function is to determine the levels of risk to which banks can expose themselves in the business of lending. Even prior to the elimination of the Glass-Steagall restrictions, monitoring risk in bank portfolios was a tricky business (evidenced by the savings and loan crisis 20 years ago). Over the last two decades, international efforts, originally codified in the Basel Accords, have attempted—with varying degrees of success and, more recently, utter failure in the application thereof—to standardize the valuation of bank assets globally. With the final abandonment, about a dozen years ago, of the Glass-Steagall separation of commercial and investment banking, bank regulators have had to contend with institutions' exposure to securities trading, underwriting, and proprietary investment activities.

Any layman who understands that banks aggregate deposits and capital, and use the proceeds to make loans, can appreciate that if a bank's loans have a poor likelihood of being repaid, the bank is equally likely to fail. The way regulators seek to prevent this outcome is to evaluate loans' credit quality and require banks to allocate their capital toward varying the percentage of each loan based on this evaluation. So, a loan made to the U.S. government (i.e., holding U.S. Treasury bills or bonds) or to a high investment-grade rated company will require little capital to support it, while a loan to a subprime borrower should require a more significant percentage.

This all works rather well if only simple mortgage loans or corporate loans are being evaluated. It works extremely well over all time horizons if there are no dramatic and sudden shifts in credit quality (such as the rapid loss of one-third of homes' values). Because federal deposit insurance makes a run on any given bank by its depositors extremely unlikely, banks can absorb moderate shifts in asset values by either maintaining or raising sufficient capital, or by waiting out an interim hiccup in the overall economy.

When, by contrast, you throw in more complex securities and other investment positions, and then permit banks to expose a significant portion of their capital to support trading activities (which, by definition, involve holding (one hopes) for the short term, assets that fluctuate constantly in value) and underwriting, you have taken the government's support for financial institutions and placed it at far more risk. And when banks take the next step—engaging in trading and investment activities over long periods and for their own account, as opposed to trading with clients—the government is supporting activity that is, in our opinion, well outside the rationale behind central bank support and depository insurance.

The assets held by many institutions—particularly relatively illiquid and highly complex derivative securities, those technically off balance sheet but highly levered, to say nothing of direct investment interests via internally or externally managed funds—are not only outside the relatively boring business of commercial banking, which governments have traditionally found to be in the public interest to charter and support (directly or indirectly); they are also nearly impossible to value conclusively for the purpose of assessing risk-based capital requirements.

During good times, when markets are robust, regulators in most countries that comply with the Basel Accords have valued the above asset classes by "marking" them to market values. For those times when liquidity is absent from markets—which is, of course, the time the rubber meets the road from a regulatory standpoint—regulators and accounting standards boards have come up with all sorts of schemes to impute values based on modeling or comparisons. Of course, when the financial economy hits massive bumps in the road, as in 2008 and 2009, we found that we had a banking system that was (and still is, in our opinion) seriously undercapitalized.

Accordingly, we now need to reexamine exactly which types of banking and nonbanking activities deserve the protection of the federal umbrella. But we must also look at how we account even for conventional bank assets.

Modern financial institutions are sufficiently complex, in both their activities and interactions with each other and the broader economy. Trying to reinstate the Glass-Steagall barriers completely would be anachronistic. We see no difficulty, per se, with a nonbank holding company owning a properly capitalized bank holding company, as well as a proprietary trading or hedge fund—provided the operations and capitalization of the two are entirely independent, and that there is no amount of credit interdependence (such that the nonbank enterprise can fail independently of the affiliated bank).

As to where to draw the line between bank-appropriate and -inappropriate activities, particularly trading activities, we appreciate the complexities involved but, like Mr. Volcker, we do not believe the matter to be insoluble. If a bank is holding a position in a loan, security or other asset that is not being held to maturity by the institution, but is nevertheless held for an extended period or traded in very high volume, we would regard this asset as not being held as client trading inventory; rather, it is a proprietary trading asset and would require its disposition (and a ban on reacquisition, optioning or repo positioning of such an asset for a year or longer or contemporaneous like-kind offsetting trade) or the allocation of capital to 100% of the offending position. In underwriting, we would suggest that any sale of a security in connection with which an institution sells a related put or issues a credit default swap should not be regarded as a true sale and would subject the security to the same treatment as one covered by the foregoing sentence. These are but two of many important areas to cover, but the bottom line is clear: If there is the will to disaggregate inappropriate operations from the banking sector, it is entirely possible to do so.

However, we still see some regulatory issues remaining on the asset side of institutions, even after separating out the more bank-inappropriate activities. Two problems, in particular, come to mind:

(i) U.S. banks are now sitting on some nearly $5 trillion of residential and commercial mortgages ("whole loans," not securities) that unquestionably are legitimate bank assets, but are severely underwater relative to the value of the underlying collateral therefor. The debt bubble created a lending hysteria that, for the second time in the history of sophisticated multinational financial institutions (Japan during the 1990s being the first), left banks sitting on huge embedded and unrecognized losses on assets held for investment that are unlikely to be fully eliminated merely by the passage of time. To experience years on ongoing loss recognition will stymie recovery of both banks and the general economy. Sooner resolution of these troubled assets is therefore imperative.

(ii) Accounting standards and conventions were heavily stretched over the last 15 years to accommodate progressively more leveraged banking and other financial company operations. This is a subject worthy of its own essay, but suffice it to say that some of the assets reflected in the calculation of regulatory capital (Tier 1 capital) need to be questioned as to their value if an institution, or an economy, is under stress. Attention must be paid to this issue, as during the crisis we saw balance sheets of thinly capitalized financial institutions (with FannieMae and FreddieMac being the poster children) that were nominally solvent from a regulatory standpoint, being supported by assets such as deferred tax benefits and goodwill that really have zero value at times when capital is needed most.

Limiting Liabilities and Contingent Forms of Leverage

Let's start this subject off by noting that we are much more comfortable now that financial institutions have been working to raise their Tier 1 capital and tangible common equity ratios from the thinly capitalized levels of the "naughties." Now all that is left to be done on the equity side of the balance sheet is to codify these new levels and ensure that minimum regulatory capital reaches and remains around 14% to 15% of total assets for the largest financial companies (and we'd like to see corresponding tangible common equity minimums established as well) during normal times. For nonsystemically critical/threatening smaller institutions, a lower level of capital thresholds—similar to, or slightly higher than, current requirements—would be sufficient, especially if they eschew the use of nondeposit leverage.

Having said that, we also suggest that a revamped regulatory system include the concept of dynamic capital requirements. The higher capital margins that we believe should apply to larger institutions should have some "give" built into them. During flush periods of the business cycle, these higher requirements would salt away capital for leaner times. Therefore, financial institution capital can be permitted by regulators to fall several percentage points during times of distress, without shutting down the operations of institutions falling below optimal capital levels.

Higher institutional capital ratios would, in and of themselves, go a long way toward limiting nondeposit liabilities, as there would be less leverage in general on the balance sheet. But this will not completely solve the problem of systemically threatening financial institution liabilities.

It is true that large banks' nondeposit liabilities are more closely linked than deposits to the nontraditional operations of these institutions. But this is not universally the case. And leverage, per se, is not the universal enemy, either. Too much of it certainly is. But just as important as quantity are the issues of duration and to whom debt is owed.

Deposits, which are also bank liabilities, tend to be "sticky," as discussed earlier, because they are insured. A depositor may pull his money out of a bank to get a better return from another bank (and the internet has seen deposits become generally more mobile), but as long as his funds deposited in any given institution are below the FDIC insurance cap, a bank customer is more likely to stay put. Bonds and other bank debt, on the other hand, mature, sometimes daily; if liabilities consist of auction rate instruments or repo lines. Building a banking system on short-term lines of credit is extremely dangerous, given the mismatch against comparatively long duration banks assets.

But what is more dangerous than using large financial institutions' assumed credit to issue short-term debt is using that same credit, explicitly or implicitly, to further lever through contingent liabilities. When a division of any large regulated financial institution issues a credit default swap, "sponsors" a theoretically off-balance sheet investment vehicle, or enters into any other sort of financial guarantee or "put" contract, it is—despite the commercial and collateral details of such arrangements—levering the credit of its regulated holding company.

The most extreme example of the foregoing in the history of the bubble was AIG's Financial Products Unit, which issued credit default swaps off the credit of its parent from a subsidiary that was essentially without capital. None of these liabilities, of course, appears on the parent company's balance sheet, nor do they involve the posting of capital. They are all "out of the money" when issued (i.e., the issuing institution, based on the value of the securities it is guaranteeing, has no liability at the date of issuance), but are, of course, ticking time bombs in a market meltdown. Sponsored, off-balance-sheet funds—such as the now-discredited SIVs—are similarly troublesome because the failure of a sponsored fund creates practical issues relative to a firm's franchise and legal issues for an institution relative to the parties damaged. Credit guarantees are, of course, insurance by another name.

Financial institutions tend to borrow from bigger institutions. The largest institutions borrow from, and lend to, each other to balance their overall exposures. If all financial institutions operated with the prudence and care that they should (as they almost certainly would if management had its own capital at risk and no offsetting incentives to take imprudent risk), we needn't worry about interinstitutional borrowing and lending. Alas, such is not the case, and one of the biggest systemic threats that remains with us is that of large institutions with interlinked risk resulting from the liabilities they have to each other.

So, we'd like to offer a number of corollaries to the administration's policy suggestions made to date with regard to nondeposit liabilities:

1) Let's primarily rely on hefty capital requirements to buffer the system against nondeposit liabilities that banks carry and focus disincentives (by way of taxes or other means) on those nondeposit liabilities that are owed to other regulated financial institutions. After all, if an unregulated lender (individuals or hedge funds that manage money for unregulated institutions, for example) lends money to an institution that ultimately fails, the safety net needn't be brought out to rescue the entire system. A similar concern exists with regard to interinstitutionally held preferred shares.

2) In computing nondeposit liabilities, careful restrictions must be placed on regulated institutions, using their balance sheets to earn money through taking on contingent liabilities—the threat of which can only truly be computed during times of crisis. (That internal modeling has proved to be somewhat unreliable, would be understatement.)

3) Finally, we need to curtail the use of short-term nondeposit liabilities to position market-sensitive assets. Our view is that assets that would otherwise qualify for discounting by the Fed are acceptable collateral for interinstitutional short term lending. Beyond that, look to the unregulated loan sharks (who, we don't think, would get much business from regulated institutions given the asset position limits suggested under the Volcker Rule).

Compared to the status quo of the past dozen or so years, the foregoing may seem draconian. But making a comparison to a regulatory environment that resulted in financial Armageddon is disingenuous. Bankers of the Glass-Steagall era would have been thrilled to have the institutional flexibility of a regulatory environment that included the forgoing restrictions. And somehow, even under Glass-Steagall, the American economy had some really terrific years!

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